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In the Supreme Court of the United States

OCTOBER TERM 1942

No. 1018

L. A. WELLS CONSTRUCTION COMPANY,
Petitioner and Appellant Below,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent and Appellee Below.

PETITION FOR WRIT OF CERTIORARI
To the United States Circuit Court of Appeals
For the Sixth Circuit
and
BRIEF OF PETITIONER.

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The Gates Legal Publishing Co., Cleveland, Ohio—Main [illegible]

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L. A. WELLS CONSTRUCTION COMPANY,
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PETITION FOR WRIT OF CERTIORARI
To the United States Circuit Court of Appeals
For the Sixth Circuit.

To the Honorable, the Supreme Court of the United States:

This petition of the L. A. Wells Construction Company respectfully shows:

STATEMENT OF THE MATTER INVOLVED.

Petitioner is a corporation, incorporated under the laws of the State of Delaware, having its principal place of business at Cleveland, Ohio. On May 10, 1940, it filed its petition before the United States Board of Tax Appeals for a redetermination of the deficiency determined by the Commissioner of Internal Revenue set forth in his letter Cleveland IRA:90D, dated February 12, 1940. The petition was in the nature of an appeal from the determination by the Commissioner that the petitioner was not entitled to the deduction in its 1937 tax return of an established loss sustained upon a unit price contract with the Buffalo Sewer Authority for the laying of a sewer under Black Rock Channel, Buffalo, New York, because in the opinion of the

Commissioner the petitioner was required to report its income in connection with this particular contract on the completed contract basis since in a few isolated instances in former years it had so reported income.

The facts upon which Petitioner relies as the basis for this proceeding are as follows:

(a) Petitioner is and has been since 1926 engaged chiefly in marine construction work under contracts that vary in their classification according to their terms of compensation.

(b) During the period in which Petitioner has been so engaged it has entered into various types of contracts, which may be classified as follows: (1) "Unit Price" contracts, (2) "Lump Sum" contracts, and (3) "Cost Plus a Fixed Fee" contracts, with a guaranteed maximum.

(c) Petitioner, during said period, has kept its books of account on the basis of the accrual method of accounting and has consistently filed Federal Income Tax Returns on that basis.

(d) During the taxable year 1937, Petitioner entered into and commenced operations upon a "unit price" contract with the Buffalo (New York) Sewer Authority, for the laying of a sewer under Black Rock Channel, Buffalo, New York. By the close of the taxable year, December 31, 1937, said project in accordance with Engineers' estimates had been 46.96% completed and Petitioner had expended in connection therewith the sum of $244,396.30. The Buffalo Sewer Authority, in keeping with the terms of said "unit price" contract, had passed estimates in the sum of $182,189.62 and on the basis of the Engineers' estimates Petitioner had computed as an established loss on said project the sum of $61,031.40. In accord with its method of accounting and for the purpose of clearly reflecting its income for the taxable year 1937, Petitioner set up as a specific deduction to meet said established loss, the said sum of $61,031.40.

The Petitioner contends that the Commissioner erred in his determination by reason of the fact that such determination is contrary to Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> Article 42-4. "Long-term contracts. Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this article the term 'long-term contracts' means building, installation, or construction covering a period in excess of one year."

ARGUMENT.

POINT I.

PETITIONER'S METHOD OF ACCOUNTING CLEARLY REFLECTED INCOME FOR THE YEAR 1937.

The Petitioner has been, since 1926, engaged principally in marine construction work embracing dredging, building of breakwaters, and the performance of subaqueous construction work of all kinds and has filed its income tax returns in all those years on the calendar year basis. During this period Petitioner has undertaken some forty-five to fifty projects annually, completing in all five hundred to six hundred contracts. Of this entire number seven contracts were commenced in one calendar year and completed in the next calendar year, although so far as indicated the evidence does not disclose, with the exception of the Buffalo Sewer Authority contract, whether these projects contemplated or required a period of more or less than twelve months for completion.

Under the method of accounting employed by Petitioner, it has been the practice, in connection with projects undertaken, to enter currently on its books the receipts from such projects and the expenditures incurred thereon; the profit or loss on each such project was reflected in Petitioner's income upon the completion of each undertaking. With the exception of the seven contracts hereinbefore

noted profit or loss on each project has been reflected in the year such project was undertaken. Petitioner's income tax returns, based on the accrual method of accounting, have been filed annually with the Collector of Internal Revenue for the Eighteenth District of Ohio.

On August 16th, 1937, Petitioner commenced work under a contract with the Buffalo (N. Y.) Sewer Authority for the construction of an intercepting sewer and sewage treatment plant at Buffalo, N. Y. and the terms of the contract provided for completion of the project in 225 consecutive calendar days from commencement of work unless such period should be extended by the Authority. Petitioner completed the project on or about July 10, 1938.

REASONS FOR GRANTING THE WRIT.

On February 11, 1943, the Circuit Court of Appeals of the United States for the Sixth Circuit affirmed the decision of the United States Board of Tax Appeals upon the grounds and for the reasons set forth in the opinion of the Board of Tax Appeals filed February 11, 1942.

The United States Board of Tax Appeals in its opinion found that since contracts undertaken by the Petitioner in one calendar year and completed in the following calendar year were reported by the Petitioner on the completed contract basis; that the Petitioner was thereby required to report the contract involved in this controversy on the same basis.

The Petitioner contends that this is error, since in the absence of testimony to the contrary, the Petitioner is entitled to the presumption that the contracts reported on the completed contract basis were in fact long-term contracts; and that the contract in question having been completed in less than twelve calendar months in pursuance of the requirements of said contract, that it should not and as a matter of law could not have reported it on the completed contract basis.

The holding of the United States Board of Tax Appeals and the Circuit Court of Appeals is believed to be patently erroneous and the interest of the law require that it be reversed.

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended, 28 U. S. C. A., Section 347(a).

PRAYER.

WHEREFORE, your petitioner prays that a writ of certiorari may issue out of and under the seal of this Honorable Court directed to the United States Circuit Court of Appeals for the Sixth Circuit, commanding said Court to certify and send to this Court for its review and determination, on a day certain to be therein named, a full and complete transcript of the record of all proceedings in the case numbered and entitled on its docket No. 9294, the L. A. Wells Construction Company, Petitioner-Appellant, vs. Commissioner of Internal Revenue, Respondent-Appellee, and that said judgment may be reversed by this Honorable Court and that your Petitioner may have such other and further relief in the premises as to this Honorable Court may seem meet and just.

THE L. A. WELLS CONSTRUCTION COMPANY,

By: MEYER A. COOK,

Its Solicitor.

In the Supreme Court of the United States

OCTOBER TERM, 1942.

No. . . . .

THE L. A. WELLS CONSTRUCTION COMPANY,
Petitioner and Appellant Below,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent and Appellee Below.

BRIEF FOR PETITIONER.

STATEMENT OF CASE.

Throughout the brief the parties are referred to as they stood in the Court below.

This cause involves the assessment of a deficiency in income and excess profits taxes for the year 1937. The income tax deficiency asserted is Twenty Thousand Nineteen Dollars and Fifty-nine Cents ($20,019.59) and the excess profits tax deficiency asserted is One Thousand Seven Hundred Three Dollars and Ninety-seven Cents ($1,703.97). The said deficiency was proposed in the Commissioner's letter (Cleveland I R A: 90 D) dated February 12, 1940.

The hearing in the United States Board of Tax Appeals was had before the Honorable Bolon B. Turner on May 2, 1941 at Cleveland, Ohio, on oral testimony of Howard L. Pittinger, Treasurer of appellant company, and decision for the respondent Commissioner was entered on February 16, 1942, 46 B. T. A. No. 42. It is from this decision of the Board and the affirmation of the Circuit Court that this appeal is directed.

The Circuit Court of Appeals for the Sixth Circuit, on February 11, 1943, affirmed the decision of the Board of Tax Appeals upon the grounds and for the reasons set forth in the opinion of the Board.

QUESTIONS PRESENTED.

1. In accordance with the method of accounting employed by appellant, did the deduction of a loss of Sixty-one Thousand Thirty-one Dollars and Forty Cents ($61,031.40) sustained by appellant in the year 1937, clearly reflect appellant's income for the year 1937?

2. Did the Board err in sustaining the Commissioner's determination that appellant's contract with the Buffalo (N. Y.) Sewer Authority was a long term construction contract within the meaning of Treasury Regulations pertaining to construction contracts?

STATUTES AND REGULATIONS INVOLVED.

Revenue Act of 1936 c. 690, 49 Stat. 1666:

> Sec. 41. "The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year." (26 U. S. C. A. 41.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

> Article 41-1. "*Computation of net income.* Net income must be computed with respect to a fixed period.

Usually that period is 12 months and is known as the taxable year. Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it."

Revenue Act of 1936 c. 690, 49 Stat. 1666:

Sec. 42. "The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *" (26 U. S. C. A. 42.)

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Article 42-4. "*Long-term contracts.* Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this article the term 'long-term contracts' means building, installation, or *construction contracts covering a period in excess of one year.* * * *" (Emphasis ours.)

ARGUMENT.

POINT I.

APPELLANT'S METHOD OF ACCOUNTING CLEARLY REFLECTED INCOME FOR THE YEAR 1937.

The L. A. Wells Construction Company has been, since 1926, engaged principally in marine construction work embracing dredging, building of breakwaters, and the performance of subaqueous construction work of all kinds and has filed its income tax returns in all those years on the calendar year basis. During this period appellant has undertaken some forty-five to fifty projects annually, completing in all five hundred to six hundred contracts. (Rec. p. 12.) Of this entire number seven contracts were commenced in one calendar year and completed in the next calendar year, although so far as indicated the evidence does not disclose, with the exception of the Buffalo Sewer Authority contract, whether these projects contemplated or required a period of more or less than twelve months for completion.

Under the method of accounting employed by appellant, it has been the practice, in connection with projects undertaken, to enter currently on its books the receipts from such projects and the expenditures incurred thereon; the profit or loss on each such project was reflected in appellant's income upon the completion of each undertaking. With the exception of the seven contracts hereinbefore noted profit or loss on each project has been reflected in the year such project was undertaken. Appellant's income tax returns, based on the accrual method of accounting, have been filed annually with the Collector of Internal Revenue for the Eighteenth District of Ohio.

On August 16th, 1937, appellant commenced work under a contract with the Buffalo (N. Y.) Sewer Authority for the construction of an intercepting sewer and sewage treatment plant at Buffalo, N. Y. and the terms of the contract provided for completion of the project in 225 consecu-

tive calendar days from commencement of work unless such period should be extended by the Authority. (Rec. p. 12.) Appellant completed the project on or about July 10, 1938.

During November, 1937, appellant encountered subsurface difficulties which had not been anticipated and these resulted in labor costs and material costs far greater than had been estimated at the time appellant had prepared its estimates of costs for the entire project. By December 31, 1937, progress payments to appellant totalled $182,189.62, received or accrued, but expenditures paid or incurred totalled $244,369.30, or $62,179.62 in excess of progress payments. On December 31, 1937, appellant debited an account on its books designated "Cost of Jobs—Miscellaneous" with an amount of $61,031.40, with the following explanation:

"Buffalo Sewer Authority Job in progress as of Dec. 31, 1937—Cost	$244,369.30
Estimates allowed on 46.96% of project completed to Dec. 21, 1937	$182,189.62
Cost is 134% of estimates allowed.	
Completed contract price is $382,249.02. Continued loss at 134% would cost $512,213.69 to complete causing a loss of $129,964.66.	
46.96% of $129,964.66 represents known loss as of Dec. 31, 1937	$61,031.40"

The Board in its opinion (Rec. p. 16) said:

"* * * The testimony of its (appellant's) secretary-treasurer, who had charge of its books, shows that under petitioner's method of accounting for and reporting income from such contracts it was its practice to report the income received and the costs incurred with respect to specific projects in its return for the year of completion. Such a practice contradicts the petitioner's contention that it kept its books and filed its return on the accrual basis."

Citing *H. Stanley Bent,* 19 B. T. A. 181; affirmed, 56 Fed. (2nd) 99.

The Board further said:

> "From the evidence it is apparent that the petitioner accounted for and reported its income by the completed contract method."

We respectfully submit that such is *not* the case. (Emphasis ours.) The evidence shows that some five to six hundred contracts were commenced and completed by appellant of which number but seven, including the Buffalo contract, were carried over from one calendar year to the next. The basis of accounting for the very great majority of appellant's contracts was the accrual method insofar as these were reported for income tax purposes. As was said by *Roswell Magill* in 46 *Harvard Law Review* 948:

> "Income can be said to have been realized on the accrual basis upon (1) the completion of those operations on the part of the prospective recipient, for which the money or money equivalent is to be paid, plus (2) the happening of a sufficient number of events to make it reasonably probable that a determinable amount of money or its equivalent will in fact be finally paid."

The Board further said (Rec. p. 16):

> "With respect to the Buffalo project the petitioner, under the guise of a reserve for loss, seeks to depart from its established practice of accounting for and reporting income and to deduct in its 1937 return an amount ($61,031.40) representing a proportion of its total estimated loss on the project. Where, as here, the method of accounting employed by the taxpayer clearly reflects income, to permit such departure could not result in the petitioner's net income being computed 'in accordance with the method of accounting regularly employed in keeping the books of such taxpayer,' * * *."

Appellant's "departure" from "the method of accounting regularly employed" in keeping its books was in deducting from its 1937 return "under the guise of a reserve for loss," the sum of $61,031.40. A proper application of the method employed by appellant would have resulted in clos-

ing into its profit and loss account the sum of $62,179.62 (1.84% greater than amount actually deducted), the amount by which its expenditures, paid or incurred in 1937 in connection with the Buffalo project, exceeded its receipts, received or accrued in connection with said project. Those figures appeared in the books of appellant as of December 31, 1937. To justify his disallowance of the reserve set up by appellant the Commissioner then, and in this the Board supports his viewpoint, seeks to apply the "completed contract basis" under the Treasury Regulation applicable to "long-term contracts."

POINT II.

APPELLANT'S CONTRACT WITH THE BUFFALO SEWER AUTHORITY WAS NOT A "LONG TERM CONTRACT" WITHIN THE TREASURY REGULATIONS.

Appellant's contract with the Sewer Authority provided by its terms for completion of construction *within 225 consecutive calendar days* from August 16, 1937, unless such period should later be extended by the Authority. (Rec. p. 12.) Work was commenced on the project on August 16, 1937 and was completed on July 10, 1938. The very nature and terms of the contract contemplated a completion of the project within *less than twelve consecutive calendar months.*

The Treasury Regulations provide that a taxpayer may, if he elects to do so, file his income tax returns, *under certain conditions,* on the long-term contract basis. Article 42.4, Treasury Regulations 94, provides as follows:

> "Long-term contracts.—Income from long term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this article the term 'long-term contract' means building, installation, or construction contracts covering a period in excess of one year. Person whose income is derived in whole or in part from such contracts

may, as to such income, prepare their returns upon either of the following bases:

(a) Gross income derived from such contracts may be reported upon the basis of percentage of completion. * * *

(b) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. * * *''

Pursuant to these regulations only ''long-term contracts'' defined as being those ''covering a period in excess of one year'' could be reported on the alternative ''completed contract basis.'' As is indicated in Volume 1, *Paul and Mertens, Law of Federal Income Taxation,* Paragraph 11.106:

''The regulations issued under the several statutes have provided for alternative bases for reporting income from long-term contracts. These regulations recognize the peculiar situation of building and construction contracts extending over a period of years and are a valid attempt *to allocate income equitably over a period of years.''*

The Board in its findings of fact (Rec. p. 12) states:

''So far as disclosed none of these contracts (seven in number) under which projects were begun in one year and completed in the following year contemplated or required a period in excess of 12 months for completion.''

If this be the case and assuming that none of the seven contracts contemplated or required a period in excess of 12 months for completion, appellant, under the regulations, should not have been permitted to use the long-term contract method as an elective in reporting its income for any year, nor under those circumstances should the Commissioner be permitted to depart from the accrual method of accounting and apply a regulation, use of which would not

be permitted the taxpayer. The Board in its opinion states (Rec. p. 17):

> "The regulations under all acts since the Act of 1918 contain the same definition of long-term contract as appears in Article 42-4 of Regulations 94. The rule in the above mentioned cases is grounded not on the length of time covered by the contracts but on the taxpayer's method of keeping books and reporting income, and, as we said in the *Bent* case, 'The fact that some of the contracts were performed within a year and some took longer creates no inconsistency in the method and does not detract from a clear reflection of income'."

But in the *Bent* case, 19 B. T. A. 181, referred to in the Board's opinion, we note, at page 185, the following:

> "Furthermore, since the deficiency has been determined by this method and petitioner *has not established* what in fact was the income resulting from the method he suggests, with the consequent tax liability, the deficiency could not be set aside *on the record* in any event." (Emphasis ours.)

We submit that in the instant case appellant's true income for 1937 *has been established* from the facts adduced and the method of accounting employed, and by that method and not by the Commissioner's determination appellant's income for 1937 was clearly reflected.

The Board of Tax Appeals in *Robert M. Robinson v. Commissioner,* Docket No. 106,037, entered August 30, 1941 in a memorandum opinion, reported at C. C. H. Dec. 12,056-B, said:

> "Even if petitioner had undertaken to use the long-term contract method it would have been the duty of the Commissioner to have refused it under his regulations, because the uncontradicted evidence is that all of petitioner's contracts covered a period of less than twelve months."

With this appellant is in accord. In now seeking relief from the Commissioner's strained and unauthorized use of

the inapplicable "long-term contract" regulation, appellant is not seeking the assistance of this Court in applying a stroke of legerdemain to evade payment of income tax justly due, but rather is asking that this Court apply the principle laid down by the Board in *Owen-Ames-Kimball Company*, 5 B. T. A. 921:

> "This petitioner asks that the income from the 13 long-term contracts described in the findings of fact, for each of the years under consideration, *be redetermined upon the accrual basis*, that is, by treating the *income as accruing during the progress of the work* under the contracts and *allocating* the *income to the years in which* it was *actually earned*. If the income from long-term contracts is computed in such a manner, all items of income and expense will be consistently accounted for upon the accrual basis, which will clearly and correctly reflect petitioner's net income. But the Commissioner takes exception to this method of accounting for income derived from long-term contracts, on the ground that under most of these contracts the commissions or fees, representing the petitioner's profits, were not due and payable until completion and acceptance of the work and could not be considered as income prior to the time they became due and payable. We think the manner of accounting for income from long-term contracts on the basis contended for by the petitioner is proper under the accrual method of accounting. The accrual method of accounting requires that at the end of every accounting period all income which has been earned during the period must be accounted for as income accrued in that period, though perhaps not collected, because it is not due and will not be collected until some future date. It contemplates that the income shall be determined on the basis of a fair distribution between the periods during which the income accrues. Under such a system of accounting a taxpayer accrues income, it does not receive it. *Appeal of Clarence Shock*, 1 B. T. A. 528 (1925 C. C. H., B. T. A. 2350). Accounting for the income on the basis contended for by the petitioner, the income from long-term contracts is apportioned between the tax-

> able years in the same ratio that the work completed in each year bears to the whole, thus accruing the income in the years in which it was actually earned. It conforms entirely with the accrual method of accounting and, as we have said before, the accrual method will clearly reflect the petitioner's net income." (Emphasis ours.)

The method, adopted by the Commissioner and sustained by the Board, results in a distortion of income plainly contrary to the facts. It seeks to impose upon the taxpayer an asserted deficiency in income and excess gross profits taxes amounting to $21,723.56 arising out of an accounting for the proceeds of a contract which resulted in a net loss to appellant of $95,343.23. In *Bradstreet Co. of Maine v. Commissioner,* 65 Fed. (2nd) 943, the Court said:

> "The burden to adopt a method that will clearly reflect income is on the Commissioner equally as well as on the taxpayer."

Both the Board of Tax Appeals and Circuit Court of Appeals seem to overlook the fact that reporting income from *long-term* contracts on the completed contract basis is not inconsistent with the accrual method of accounting for operations requiring less than twelve calendar months.

The finding by the Board of Tax Appeals is that "so far as disclosed, none of the petitioner's contracts of that type covered a period in excess of twelve months from beginning until completion." It is submitted that in the absence of a showing by the respondent in the record that those preceding contracts were not in fact long-term contracts, the petitioner is entitled to the presumption that they were long-term contracts in that they each required in excess of twelve calendar months.

It is therefore submitted that under the Revenue Act and related regulations it is contrary to law to require that the contract in question be reported on the completed contract basis.

In the text material of *Federal Income Gift And Estate Taxation* by Rabkin & Johnson, 1942 Edition, in paragraph E2 8 under the heading "Long-Term Contracts" we find the following:

> "* * * 'The term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year from the date of execution of the contract to the date on which the contract is finally completed and accepted. Reg. Sec. 19.42-4. But in *Wells Construction Co.,* 46 B. T. A. 302, the taxpayer was held bound to the completed contract method adopted by it with respect to a contract executed in one year and completed in the next, even though the length of the contract was less than one year. Cf. *Robert M. Robinson,* B. T. A. Memo. Dock. 106037, C. C. H. Dec. 12,056-B. The Regulations permit the reporting of long-term contracts under the "percentage of completion" method or the "completed contract" method; but this does not prevent a taxpayer from reporting long-term contract income consistently on the cash basis. G. C. M. 22682, C. B. 1941-1, 307.' "

CONCLUSION.

It is urged that if the decision of the United States Board of Tax Appeals is sustained the appellant will be subjected to an obvious injustice by a strained and unauthorized application on the part of the Commissioner of Internal Rvenue of an inapplicable Treasury Regulation.

The appellant was justified in accounting for its income for the year 1937 in the manner adopted by it. Its recording of the transaction with the Buffalo Sewer Authority reflected more accurately its true income for that year than did the measures taken by the Commissioner. Surely it cannot be determined that income was realized from a venture that resulted in an indisputable loss in excess of Ninety-five Thousand Dollars when such determination seeks its justification by the application of a yard-stick, use of which properly would be denied taxpayer.

This Honorable Court, therefore, is requested to recognize the obvious injustice of the decision of the United States Board of Tax Appeals and exonerate this appellant from the burden of the deficiency asserted to the extent indicated.

Respectfully submitted,

MEYER A. COOK,
Solicitor for Petitioner.

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CITATIONS

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In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 1018

THE L. A. WELLS CONSTRUCTION COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 10–18) is reported in 46 B. T. A. 302. The Circuit Court of Appeals promulgated no formal opinion.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on February 11, 1943 (R. 27). The petition for a writ of certiorari was filed on May 10, 1943. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended.

QUESTION PRESENTED

Whether the Circuit Court of Appeals correctly sustained the Board of Tax Appeals' determination that the taxpayer kept its books and reported its taxable income on the completed-contracts basis, and therefore was not entitled under Section 41 of the Revenue Act of 1936 to deduct in the taxable year, 1937, an amount estimated and set up in a reserve as an accrued loss upon a contract begun in that year, and completed less than 12 months later in the following year.

STATUTE AND REGULATIONS INVOLVED

The pertinent statute and regulations involved are set forth in the Appendix, *infra*, pp. 11–16.

STATEMENT

The facts found by the Board of Tax Appeals may be stated as follows (R. 11–15):

Since 1926 petitioner has been engaged principally in marine construction work embracing dredging, the building of breakwaters, and the performance of subaqueous work of all kinds, and filed its income tax returns on the calendar year basis. During this period petitioner has undertaken on an average of from 45 to 50 projects annually. Prior to 1935 all projects begun during a given year were completed within that year. In 1935 it began one project which was not completed until the succeeding year. In 1936 it began four projects which were completed in 1937. In 1937

it began two projects which were completed in 1938. So far as disclosed, none of the contracts under which projects were begun in one year and completed in the following year contemplated or required a period in excess of 12 months for completion. (R. 11–12.)

One of the projects begun in 1937 and completed in 1938 was the construction of an intercepting sewer and sewage treatment project at Buffalo, New York, sometimes referred to as the Buffalo project. The contract for the project was with the Buffalo Sewer Authority, and was approved on August 14, 1937. It provided for the completion of the project in 225 consecutive calendar days from the date of notice by the Authority to proceed with the work, unless such period should later be extended by the Authority. The specifications and contract contemplated completion of the project as a whole, and that was the petitioner's understanding in submitting its bid. The project was shown, however, in 17 separate items; payments as to four were to be made on the lump sum basis, while as to the others payment was to be made at a unit price. At the time the petitioner entered into the contract, it was estimated that the total amount to be received for the completion of the project would be $382,249.02, and the performance bond given by the petitioner to the Authority was for that amount. (R. 12.)

The petitioner began work on the Buffalo project on August 16, 1937, and completed it on or

about July 10, 1938. Under the contract the petitioner received monthly payments from the Authority based on progress estimates made by the engineers for the Authority, which in turn were predicated upon the work done and materials furnished. During November 1937 the petitioner encountered subsurface difficulties which resulted in greater labor and material costs than it originally had anticipated. By December 31, 1937, the progress estimates made by the Authority's engineers indicated that the project was 46.96% completed and totaled $182,189.62. By that time the petitioner's labor costs had amounted to $100,-349.18 and its total costs to $244,369.30, or $62,-179.68 in excess of the total of progress estimates. After it had encountered the unanticipated difficulties, the petitioner filed complaints with the Authority as the work progressed, in order to lay a basis for a formal claim if it should later decide to make a claim for compensation in excess of that provided for in the contract. Under the existing contract, however, the responsibility for judging the sufficiency of its estimates of costs and conditions affecting the execution of the project rested entirely on the petitioner. No formal claim for additional compensation was filed in 1937, but in 1938, when the work was completed, the petitioner did file with the Authority formal claim for compensation beyond that provided in the contract to cover the unanticipated costs it incurred in com-

pleting the project. In final settlement the Authority, without the contract so providing, paid the petitioner approximately $24,000 in addition to the $382,249.02 originally estimated to be paid under the contract. The petitioner's loss on the project after making allowance for the receipt of the $24,000 was $95,343.26. (R. 12–13.)

On or after December 31, 1937, the petitioner debited an account on its books designated "Cost of Jobs—Miscellaneous" with an amount of $61,031.40, with the following explanation (R. 13–14):

Buffalo Sewer Authority Job in progress as of December 31, 1937—Cost	$244, 369. 30
Estimates allowed on 46.96% of project completed to December 21, 1937	182, 189. 62

Cost is 134% of estimates allowed.

Completed contract price is $382,249.02. Continued loss at 134% would cost $512,213.68 to complete, causing a loss of $129,964.66.

46.96% of $129,964.66 represents known loss as of December 31, 1937.

In its income tax return for 1937 the petitioner deducted as a reserve for loss on the contract the $61,031.40, computed in the foregoing manner (R. 14).

With respect to projects begun in one year and completed in the subsequent year, even though on a unit price basis, it has been the practice of the petitioner to enter currently on its books the receipts from such projects and the expenditures incurred thereon, but under the method of accounting employed by it the profit or loss on such projects was not reflected in its income until the

year of completion of the projects. It has been the practice of the petitioner in filing its income tax returns to report in the year of completion the gain or loss resulting from projects begun in the preceding year and completed in the current taxable year. (R. 14.)

In conformity with that practice, the petitioner in filing its 1937 return completely ignored the Buffalo project so far as income and expenditures were concerned, except to deduct as a reserve the $61,031.40. In its income tax return for 1938, the petitioner showed the total receipts and the total expenses of the Buffalo project and from the expenses subtracted the $61,031.40 taken in its 1937 return, thereby taking as a loss in 1938 on the project the difference between $95,343.26, loss actually sustained, and $61,031.40, deducted as a reserve in 1937, or the amount of $34,311.86. After thus taking the $34,311.86 as a loss, the petitioner reported a loss in 1938 of about $20,000. (R. 14.)

In sustaining the Commissioner's disallowance of the deduction of $61,031.40, the Board of Tax Appeals found that the taxpayer accounted for and reported its income by the completed contract method (R. 16). It concluded that to permit a departure would result in the taxpayer's income not being computed "in accordance with the method of accounting regularly employed" in keeping its books, as required by Section 41 of

the Revenue Act of 1936, and would result in a distortion of income for both 1937 and 1938 (R. 16). The Circuit Court of Appeals entered a judgment of affirmance "upon the grounds and for the reasons set forth in the opinion of the Board" (R. 27).

ARGUMENT

The Board's finding that the petitioner accounted for and reported its income upon the completed contract method was based on the testimony of the latter's secretary-treasurer who had charge of its books (R. 16). The petitioner insists that the finding is erroneous (Br. 12), but it did not request that the evidence taken in the case be transmitted to the Circuit Court of Appeals (R. 24); upon review, therefore, there was no basis upon which it could be concluded that the Board's finding was not supported by substantial evidence. Cf. *Badgley* v. *Commissioner*, 59 F. 2d 203 (C. C. A. 2d); *Tricou* v. *Helvering*, 68 F. 2d 280 (C. C. A. 9th), certiorari denied, 292 U. S. 655.

As the Board concluded, the deduction claimed by the petitioner for 1937 clearly constituted a departure from the completed contract method of accounting. Under this method, the entire loss on the contract would be taken in 1938. Instead, the loss is sought to be spread between the two years 1937 and 1938. To permit such a change

with respect to this particular contract would plainly result in a distortion of income for the years involved. It would directly contravene both the clear language of the statute and the provisions of the applicable regulations. Revenue Act of 1936, Section 41; Treasury Regulations 94, Article 41-1 (Appendix, *infra*).

The petitioner, as we understand its argument (Br. 13–17), also contends that it could not be held to the completed contract method of accounting because the regulations provide for its use only in connection with long-term contracts, which are defined as contracts covering a period in excess of one year, and it does not appear that the petitioner's contracts contemplated more than 12 month periods. Treasury Regulations 94, Article 42–4, Appendix, *infra.* The petitioner also contends that in any event it cannot be held to that method of reporting income on this particular contract which was of less than 12 months' duration. (Br. 17.) But there is nothing in the regulations to prevent a taxpayer from adopting a method of accounting by which income from contracts begun in one taxable year and completed in another would consistently be returned in the year of completion of the contracts although some or all of the individual contracts would be completed in less than a single year. Indeed, the regulations specifically point out that no uniform method

of accounting can be prescribed for all taxpayers, and that each taxpayer shall adopt such forms and systems of accounting as in his judgment are best suited to his purpose. Treasury Regulations 94, Article 41-3, Appendix, *infra*. The test is whether the method consistently followed will clearly reflect income.[1] It appears here that both the Commissioner and the Board thought that it did (R. 16). Plainly, there was no occasion to disturb this determination upon review.[2] Cf. *Brown* v. *Helvering*, 291 U. S. 193, 204-205; *Lucas* v. *American Code Co.*, 280 U. S. 445, 449.

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[1] Cf. *Bent.* v. *Commissioner*, 19 B. T. A. 181, affirmed, 56 F. 2d 99 (C. C. A. 9th); *Badgley* v. *Commissioner*, 21 B. T. A. 1055, affirmed, 59 F. 2d 203 (C. C. A. 2d); *Fort Pitt Bridge Works* v. *Commissioner*, 24 B. T. A. 626, affirmed on this point, 92 F. 2d 825 (C. C. A. 3d), certiorari denied, 303 U. S. 659; *Finn* v. *Commissioner*, 22 B. T. A. 799; *Wheelock* v. *Commissioner*, 10 B. T. A. 540.

[2] The Commissioner's determination could also be sustained on the alternative ground that the deduction was not allowable since it was not evidenced by a closed and completed transaction (Treasury Regulations 94, Article 23 (e)-1, Appendix, infra) but represented mainly an estimated contingent liability.

CONCLUSION

The decision of the court below was correct. There is no conflict. The petition for certiorari should be denied.

Respectfully submitted.

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JUNE 1943.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:

* * * * *

(e) *Losses by Individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

(f) *Losses by Corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but

if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. * * *

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. * * *

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the dividends paid credit provided in section 27) provided for in this title shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (e)-1. *Losses by individuals.*—Losses sustained by individual citizens or residents of the United States and not compensated for by insurance or otherwise

are fully deductible if (*a*) incurred in the taxpayer's trade or business, or (*b*) incurred in any transaction entered into for profit, * * *

In general losses for which an amount may be deducted from gross income must be evidenced by closed and completed transactions, fixed by identifiable events, bona fide and actually sustained during the taxable period for which allowed. Substance and not mere form will govern in determining deductible losses. Full consideration must be given to any salvage value and to any insurance or other compensation received in determining the amount of losses actually sustained. * * *

* * * * *

ART. 41-1. *Computation of net income.*—Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditures which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See articles 42-1 to 42-3.) If the taxpayer does not regularly employ

a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

ART. 41-2. *Bases of computation and changes in accounting methods.*—Approved standard methods of accounting will ordinarily be regarded as clearly reflecting income. A method of accounting will not, however, be regarded as clearly reflecting income unless all items of gross income and all deductions are treated with reasonable consistency. See section 48 for definitions of "paid or accrued" and "paid or incurred." All items of gross income shall be included in the gross income for the taxable year in which they are received by the taxpayer, and deductions taken accordingly, unless in order clearly to reflect income such amounts are to be properly accounted for as of a different period. * * *

* * * * *

ART. 41-3. *Methods of accounting.*—It is recognized that no uniform method of accounting can be prescribed for all taxpayers, and the law contemplates that each taxpayer shall adopt such forms and systems of accounting as are in his judgment best suited to his purpose. Each taxpayer is required by law to make a return of his true income. He must, therefore, maintain such accounting records as will enable him to do so. (See section 54 and article 54-1.) Among the essentials are the following:

* * * * *

(2) Expenditures made during the year should be properly classified as between capital and expense; that is to say, expenditures for items of plant, equipment, etc.,

which have a useful life extending substantially beyond the year should be charged to a capital account and not to an expense account; and

(3) In any case in which the cost of capital assets is being recovered through deductions for wear and tear, depletion, or obsolescence, any expenditure (other than ordinary repairs) made to restore the property or prolong its useful life should be added to the property account or charged against the appropriate reserve and not to current expenses.

* * * * *

ART. 42–4. *Long-term contracts.*—Income from long-term contracts is taxable for the period in which the income is determined, such determination depending upon the nature and terms of the particular contract. As used in this article the term "long-term contracts" means building, installation, or construction contracts covering a period in excess of one year. Persons whose income is derived in whole or in part from such contracts may, as to such income, prepare their returns upon either of the following bases:

(*a*) Gross income derived from such contracts may be reported upon the basis of percentage of completion. In such case there should accompany the return certificates of architects or engineers showing the percentage of completion during the taxable year of the entire work to be performed under the contract. There should be deducted from such gross income all expenditures made during the taxable year on account of the contract, account being taken of the material and supplies on hand at the beginning and end of the taxable period

for use in connection with the work under the contract but not yet so applied. If, upon completion of a contract, it is found that the taxable net income arising thereunder has not been clearly reflected for any year or years, the Commissioner may permit or require an amended return.

(*b*) Gross income may be reported for the taxable year in which the contract is finally completed and accepted if the taxpayer elects as a consistent practice so to treat such income, provided such method clearly reflects the net income. If this method is adopted there should be deducted from gross income all expenditures during the life of the contract which are properly allocated thereto, taking into consideration any material and supplies charged to the work under the contract but remaining on hand at the time of completion.

A taxpayer may change his method of accounting to accord with paragraph (*a*) or (*b*) of this article only after permission is secured from the Commissioner as provided in article 41–2.

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